APRIL 2001

US OVERVIEW

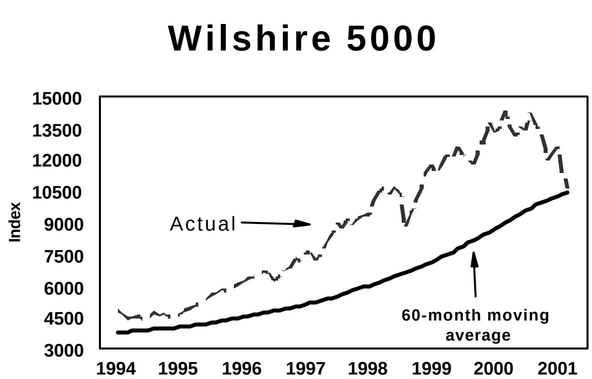
After slowing substantially in the second half of 2000, the economy appears to have avoided falling into a recession in the first quarter of 2001. Although slow growth is better than a recession, it has not prevented the unemployment rate from rising to 4.3 percent in March. In September and October, the unemployment rate was at a 30-year low of 3.9 percent. Going forward, consumer reaction to the decline in equity prices since last spring may be the key variable determining if the economy enters a recession.

Recession Avoidance?

Due to very strong sales in January – particularly for durable goods – real consumption grew at an estimated 3.2 percent annual rate in the first quarter. Real GDP appears to have grown at about a 1 percent rate in Q1, as a slowdown in business investment and an inventory correction offset consumption growth.

Despite the strong Q1 consumption growth rate, retail sales were flat in February and shrunk in March, undermining prospects for consumption continuing to prop up the economy. The ongoing strength of the housing market is a good sign for future consumption, but more pessimistic analysts emphasize weakness in the stock market, declining consumer confidence, and rising joblessness.

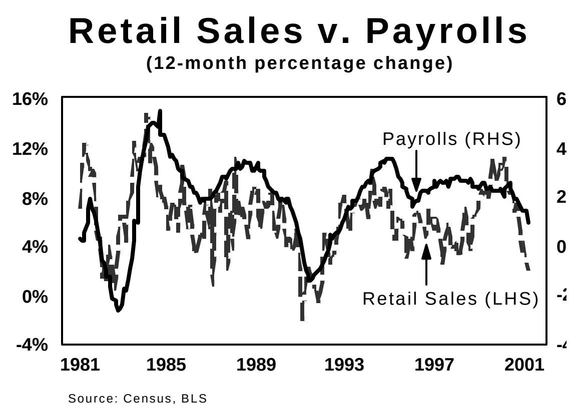
From March 2000 to March 2001 the total value of common stock traded on the New York Stock Exchange and the NADSAQ fell $4.2 trillion. Barring a sudden turnaround, this drop could unleash a "negative wealth effect" in which consumers, seeing the value of their portfolios decline, become less willing to spend. The Federal Reserve mentioned the "possible effects of earlier reductions in equity wealth on consumption" as one of the reasons it surprised the financial markets with a 0.5 percentage point interest rate cut on April 18. That rate cut put the target federal funds rate at 4.5%, down two percentage points from where it was at the beginning of the year. The futures market now expects the Fed to reduce interest rates by an additional 0.5 percentage points by the end June.

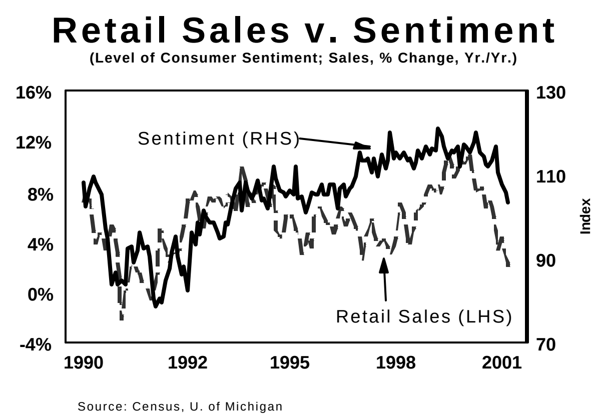


Source: Wall Street Journal

The magnitude of a negative wealth effect, however, will in large part depend on how consumers adjusted to the $13 trillion *increase* in stock market wealth from 1994 to March 2000. Although we know how much the stock market rose during that period and we know how much we consumed it will be a number of years before economists can say with any degree of confidence how much spending was due to the wealth effect and how much was due to other factors. If it turns out consumers quickly adjusted their spending habits to the stock market's rise, the recent stock market drop should cause a large negative wealth effect later this year. On the other hand, if consumers gradually increased spending due to the rise in the stock market then any future slowdown in spending due to the decline in stocks should be slight, consumers being little affected by losses in wealth they had yet to incorporate into their spending decisions.

Besides the weak stock market many analysts see declining consumer confidence and declining job growth as signs of impending declines in consumption growth, which, in turn, could tip the economy into a recession. The University of Michigan consumer sentiment index for April is at a preliminary 87.8, the lowest level since 1993. The drop in the index since November is the steepest since the 1990-91 recession. Rising claims for unemployment insurance – both initial claims and continuing claims – indicate that a higher unemployment rate is in the pipeline. However, analysts may be assuming too much about the relationship between these variables. It is difficult to discern whether

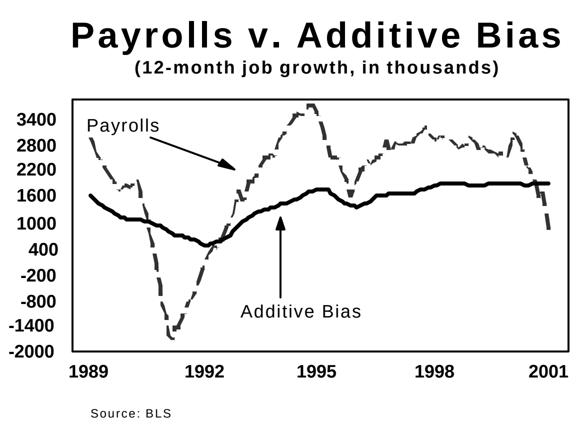




consumer confidence and payrolls predict future consumption or whether it is consumption that predicts future trends in consumer confidence and payrolls.

The Jobs Market

Given the steep drop in economic activity since the first half of 2000, the unemployment rate is likely to continue to rise even in the absence of a recession. Although the Bureau of Labor Statistics claims payrolls increased by 1.2 million during the past year (March 2000 - March 2001), there is a good reason to doubt this claim. During the past year something called the "additive bias adjustment" accounted for 1.8 million net new jobs. Were it not for the additive bias adjustment, the economy would have *lost* 630,000 jobs, not gained 1.2 million.



What is the additive bias? To make its monthly report on payrolls BLS surveys about 350,000 businesses, most of which are large firms. BLS does not get accurate data on job creation at small and medium-size firms until several months later (when it examines unemployment insurance tax filings by businesses). In the meantime BLS uses the additive bias as an estimate of job creation at businesses outside its survey range. During periods of unexpectedly strong economic growth BLS will tend to revise job growth upward when it eventually gets more accurate data. The opposite is true during economic slowdowns: BLS will sometimes revise payrolls downward due to an overestimation of activity at small and medium-size firms.

Too Much Bias?

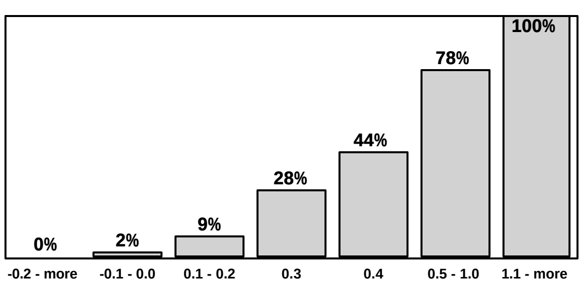
Payroll Growth	September 1989-1990	March 1999-2000	March 2000-2001
Total Job Growth	1,279,000	2,955,000	1,212,000
Based on Survey	292,000	1,110,000	-630,000
Additive Bias	987,000	1,845,000	1,842,000

At present, BLS data say that although payrolls *declined* by 630,000 during the past twelve months based on its survey data, payrolls *increased* by more than 1.8 million at small and medium-size businesses for which it does not yet have accurate information. This kind of discrepancy is highly unusual. Typically, when there is a steep slowdown in job creation by firms for which BLS has accurate data there is also a steep drop in the additive bias.

Two comparisons illuminate the unusual nature of the data. The last time total payroll growth was this weak, during an economic slowdown, was in September 1990. Back then, total twelve-month payroll growth was about 1.3 million, consisting of about 1 million jobs from the additive bias and about 300,000 jobs from the firms the BLS survey. Notice how the survey data and the additive bias were both positive. Now compare the most recent twelve months to the twelve months before that. The BLS uses an additive bias of 1.8 million for both twelve-month periods even though payroll growth excluding the additive bias was 1.1 million in the preceding twelve months and -630,000 in the most recent twelve months. It seems highly unlikely that job creation was almost exactly the same at small and medium size businesses during these two periods when job creation at larger firms was so vastly different. When BLS revises its payroll growth numbers for late 2000 and early 2001 – which will not occur until mid-2002 – do not be surprised to see a downward revision, perhaps a substantial one.

Recession Monitor

Odds of a Recession



Source: BLS, NBER

Despite this limitation, BLS data can be helpful in figuring out if the economy has entered a recession. Waiting for an "official" recession announcement by the National Bureau of Economic Research takes at least several months after a recession has begun. Waiting for at least one quarter of negative growth is also untimely. After a particular quarter ends it takes almost a full month for the Commerce Department to make its initial estimate of GDP growth. That estimate is subject to substantial revision one month later, and further revisions thereafter.

A more timely way to assess whether a recession has begun is to keep track of changes in the unemployment rate. To tell whether a particular month is later going to be declared part of a recession, watch the difference between the unemployment rate in that month and the unemployment rate three months earlier. Based on changes in the unemployment rate between 1948 and 2000, when the unemployment rate declines by 0.2 percentage points or more in a 3-month period the economy has virtually zero chance of being in a recession. If the unemployment rate is the same as it was three months ago or 0.1 percentage points lower, the odds of a recession are only 2 percent. If the jobless rate is 0.1 or 0.2 percentage points higher than three months ago the odds of a recession are still only 9 percent. An increase in the jobless rate of 0.3 raises the odds of a recession to 29 percent; an increase of 0.4 boosts the odds of a recession to 44 percent; an increase of 0.5 to 1.0 puts the likelihood of a recession at 78 percent. An unemployment increase of more than 1 percentage point makes a recession a virtual certainty.

Key Economic Indicators

Quarterly Indicators

(Q/Q, at annual rate)

	Q1-00	Q2-00	Q3-00	Q4-00
Real GDP Growth	4.8	5.6	2.2	1.0
Consumption	7.6	3.1	4.5	2.8
Business Investment	20.6	17.9	5.6	-3.3
Trade Deficit ($ bilions)	85.3	88.7	95.6	99.0
PCE Inflation	3.5	2.1	1.8	1.9
Productivity Growth	2.1	6.3	3.0	2.2

Monthly Indicators 2001

	Jan.	Feb.	Mar.
Unemployment	4.2	4.2	4.3
Payroll Growth	289K	140K	-86K
CPI Inflation (yr./yr.)	3.7	3.5	3.0
Retail Sales Growth (yr./yr.)	4.4	3.0	1.9
Corporate Rates (Baa)	7.9	7.9	7.9
Federal Funds Rate (Month End)	5.5	5.5	5.0
Dow (Month End)	10.9K	10.5K	9.9K

In March the unemployment rate was 4.3 percent, compared to 4 percent in December. This 0.3 percentage point increase puts the odds of a recession at 29% in March. To get a 0.4 increase in the jobless rate sometime during the second quarter – and thus an almost 50-50 chance of a recession having started – the jobless rate would have to rise to 4.6 percent by May or 4.7 percent by June.